Department of Finance

News Release

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IMF Report Highlights Canada's Strong Economic Performance

The report by the International Monetary Fund (IMF) Mission on Canada acknowledges that Canada's economy has outpaced those of many of the major industrialized countries. The report points out that Canada has solid economic fundamentals and a "sound policy framework" that positions the Government to weather future economic challenges.

"The IMF report confirms that we are on the right track with our long-term economic plan, *Advantage Canada*," said Jim Flaherty, Minister of Finance. "Our economic fundamentals are as strong as the Canadian Shield due in large part to our commitment to ongoing debt reduction, tax cuts and focused spending."

The IMF supports the Government of Canada's effort to strengthen Canada's economic union. The report suggests that to make the strong Canadian economy even stronger, the provinces and territories need to:

- eliminate barriers to interprovincial trade in goods and services and labour mobility;
- adopt a Common Securities Regulator; and
- reduce marginal effective tax rates on capital, including by harmonizing sales taxes.

"While the IMF report overall is very positive, it highlights the fact that we still have work to do to improve our productivity and competitiveness," said Minister Flaherty. "Our government agrees, and in fact is taking significant steps to meet that challenge. In the fall Economic Statement, we committed to reducing our business tax rate to 15 per cent by 2012, giving Canada the lowest overall tax rate on new business investment in the Group of Seven (G7) by 2011 and the lowest statutory tax rate in the G7 by 2012."

The IMF report goes on to say that flexible labour markets have helped make Canada's adjustment to the volatile dollar "remarkably smooth." The report says that "employment gains in services, construction, and mining as well as interprovincial migration have more than offset manufacturing job losses in the central provinces."

The IMF report also commends the Bank of Canada's actions in response to risks in financial markets, in tandem with other central banks, to provide liquidity to ease global

financial turbulence. It also acknowledges the Government's efforts to encourage an orderly restructuring of third-party asset-backed commercial paper.

A copy of the IMF statement is available on the Department of Finance website. The IMF will release its full report on Canada early next year.

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INTERNATIONAL MONETARY FUND

2008 ARTICLE IV CONSULTATION WITH CANADA

PRELIMINARY CONCLUSIONS OF THE IMF MISSION

December 12, 2007

1. **Canada has enjoyed an enviable macroeconomic performance over the past decade.** Reflecting prudent macroeconomic policies, structural reforms, and favorable external conditions, GDP has grown faster than in other G-7 countries, inflation has been low and stable, and fiscal balances have been in surplus. The sound policy framework will help policymakers in navigating the more challenging environment going forward and support macroeconomic and financial stability.

PROSPECTS AND RISKS

2. **After five years of strong growth, the economy is forecast to slow in the next few quarters.** Over recent years, commodity price-related terms of trade improvements have boosted real incomes and domestic demand, with reinforcement from supportive financial and labor market conditions. Notwithstanding some offset from currency appreciation and the related drag from net exports, the economy has been operating above potential. Going forward, however, the drag from external factors should intensify with a weakening U.S. economy and recent currency appreciation, while domestic demand is expected to moderate as financial conditions tighten and real income growth normalizes (Figure 1).

3. **While there are upside risks to this forecast from domestic demand, the balance of risks is tilted to the downside.** Domestic demand could remain stronger than expected, given the recent boost to real incomes from oil prices and currency appreciation. Nevertheless, large downside risks to growth increasingly outweigh the significant upside potential, given a possible U.S. recession and risks that global financial conditions could tighten further.

POLICY CHALLENGES

4. **We see the major macroeconomic challenges as**:

- *Managing conflicting risks* from domestic demand and from external/ financial conditions.
- *Adjusting to currency appreciation* and promoting *rapid productivity growth.*
- *Safeguarding financial stability* given financial strains while *fostering innovation.*
- *Improving the tax system* while *maintaining a sound fiscal position.*

Managing Conflicting Risks

5. **Monetary policy has appropriately shifted to guarding against the increasing near-term downside risks.** Following a rate increase in July on concerns about the upward creep in

core inflation, tight labor markets, and strong domestic demand, the Bank of Canada paused before cutting its policy rate on December 4. Between fixed action dates, the Bank nimbly communicated the implications of the changes in near-term risks to markets and the public.

6. **The December interest rate cut was welcome.** With the dollar at parity against its U.S. counterpart, price discovery has resulted in a surprisingly strong and rapid pass-through to consumer prices, which has alleviated inflation concerns even though output is still above potential. The Bank has appropriately repositioned its policy stance, given the changes in the global financial environment and weaker external prospects. Further decisions will partly depend on incoming data, as trade indicators suggest slowing activity while labor market developments still signal robust growth.

7. **The Bank of Canada has succeeded in keeping the overnight rate close to target, but interbank term spreads have risen.** Liquidity in Canada's interbank market has decreased in the current global financial turmoil. The Bank's standard overnight liquidity operations have stabilized the overnight rate around the policy target. As elsewhere, this has not prevented interbank term spreads from rising. While recognizing that the ability to influence interbank term spreads may be limited, the mission welcomes the Bank's decision, in tandem with other major central banks, to address elevated pressures in short-term funding markets through term liquidity operations with an expanded set of securities.

Adjusting to Currency Appreciation and Promoting Productivity Growth

8. **At parity against the U.S. dollar and with current oil prices, the dollar seems broadly in line with fundamentals, but some measures suggest modest overvaluation.** Much of the dollar appreciation since 2002 has reflected commodity boom-related pressures on domestic resource utilization and the improved external position, and has helped to rebalance demand. However, the rapid appreciation in 2007 has also reflected momentum buying and general U.S. dollar weakness. Indeed, the freely floating Canadian currency has borne a disproportionate share of the burden of the U.S. dollar adjustment. In recent weeks, the Canadian dollar has fortunately retreated from its earlier record highs where it was overvalued by most measures.

9. **The mission supports the Bank of Canada's framework for assessing exchange rate fluctuations.** The framework distinguishes equilibrating fluctuations that rebalance external and internal demand in the face of external shocks from other fluctuations. The latter may require a monetary policy response in the context of the inflation targeting framework. By communicating its exchange rate assessment, including in speeches by members of the Governing Council, the Bank can help markets better understand its views on the outlook, risks, and the policy stance, as it has done recently.

10. **With flexible labor markets, domestic adjustment to currency appreciation has been remarkably smooth, although competitiveness remains a concern.** Employment gains in services, construction, and mining as well as interprovincial migration have more than offset manufacturing job losses in the central provinces. Nevertheless, despite important productivity

gains in some sectors, competitiveness, especially in manufacturing, has suffered. Supporting competitiveness and productivity growth through removing remaining impediments to increased investment should therefore be a policy priority, as the government has recognized.

11. **The mission supports the government's structural policy agenda outlined in *Advantage Canada.*** The agenda recognizes the importance of fostering investment, including in research and development, through reducing high marginal effective tax rates on capital and broadening access to finance. In addition, boosting productivity also requires greater focus on product market reform. Restrictions on inward foreign direct investment in network industries weigh on productivity growth, given the benefits of foreign ownership for raising productivity. Barriers to interprovincial trade in goods and services and labor mobility also hamper competition and innovation. The recent Trade, Investment, and Labor Mobility Agreement (TILMA) between Alberta and British Columbia provides a model for progress elsewhere.

Safeguarding Financial Stability While Fostering Innovation

12. **Overall, the financial system appears to be in a position to weather financial turbulence.** Current capital positions allow Canadian banks to absorb substantial balance sheet losses, and the banks' exposure to the U.S. subprime market and structured credit products is generally considered to be relatively limited. But as elsewhere, funding conditions have tightened with the global repricing of risk. Together with the rise in credit risk from a slowing domestic economy and banks' exposure to U.S. markets, this is likely to curtail financing to corporates and households.

13. **A disorderly unwinding of third-party, nonbank-sponsored ABCP programs remains a major risk to investor confidence.** The immediate reason for the standstill that began in August was that the "general market disruption" (GMD) condition for liquidity support allowed foreign banks to escape commitments when programs were hit with rollover problems. Fundamentally, however, the outcome reflected the combination of weak investor due diligence, ratings that neglected liquidity risks, and a lack of transparency in a market environment where capital adequacy regulation had provided incentives for GMD-style liquidity support. The mission welcomes the government's efforts to support an orderly restructuring of third-party ABCPs, which would reinforce investor confidence in Canadian markets and avoid further strains on already illiquid markets for structured credit products.

14. **While bank regulation and supervision largely meets best practice, the mission continues to believe that securities markets would benefit from a single regulator.** The fragmented, provincial system of securities market regulation imposes high costs on issuers and investors. The automatic interjurisdictional recognition of decisions of the home regulator under the passport system is a significant step forward. Nonetheless, as in past years, the mission believes that a single regulator is the most effective way to lower costs, ensure timely policy responses, and foster consistent enforcement. More broadly, the regulators should address new challenges from financial innovation, including establishing adequate transparency for new products.

15. **Banks' resilience to balance sheet risk is a particular benefit in current times, but it partly reflects a lack of competition that likely reduces access to finance.** In Canada's universal banking system, the rule that major banks be widely held guards against takeovers (including from abroad), thereby preventing potential competitors from entering the market on a large scale through the acquisition of existing networks. This lack of contestability has led to low-risk balance sheets and high returns on equity, but has limited incentives for financial innovation and for serving higher risk borrowers, including high-growth small- and medium-sized enterprises. In the mission's view, reducing barriers to acquisition of large banks, including by foreign entities, would foster contestability and innovation in the financial system.

Improving the Tax System

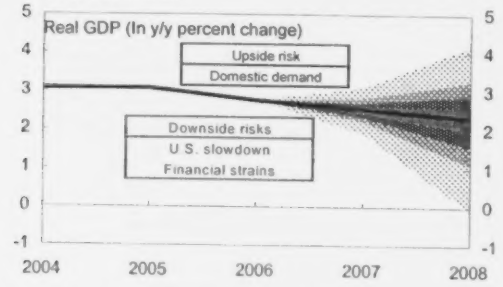
16. **A sound fiscal framework policy has paid off in an enviably strong fiscal position that makes achieving zero general government net debt by 2021 feasible.** Canada is closer to long-term budget sustainability than other industrial countries, given 10 consecutive years of budget surpluses. Noting that, under current policies, public health care spending by provinces is likely to increase rapidly, the mission welcomes the government's reaffirmation of its objective to eliminate general government net debt by 2021. This, together with health care reform, will help to alleviate long-term pressures from population aging.

17. **The mission shares the government's view that the budgetary overperformance provides room for tax relief while maintaining small budget surpluses.** With higher-than-expected nominal GDP growth and corporate income tax revenue in the current fiscal year, the federal surplus based on current policies is set to exceed the budgeted surplus by ¾ percentage points. While recognizing the risk that some of the recent revenue gains may not be permanent, the mission welcomes the proposal in the 2007 *Economic Statement* for tax relief and one-off additional debt reduction. While small in size, the related demand stimulus in 2008 will be welcome, given weaker growth prospects.

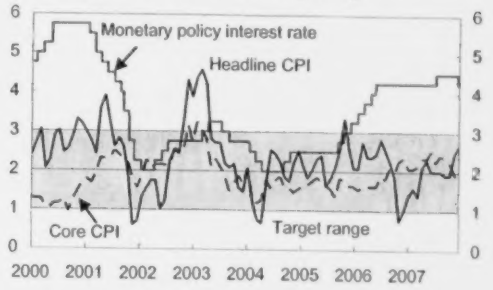
18. **As the mission observed last year, the fiscal room should be used to reduce high marginal effective tax rates on capital, saving, and labor.** Regrettably, the main tax relief measure in the *Statement* is a one percentage point cut in the federal GST rate to 5 percent. However, the mission welcomes progress in reducing high marginal effective tax rates, including the proposed one percentage point cut in the federal corporate tax rate in 2008 and its subsequent gradual reduction to 15 percent by 2012, the cut in the lower personal income tax rate, and the introduction of a Working Income Tax Benefit. The mission agrees with the government that marginal effective tax rates on capital should be further reduced significantly through the harmonization of the sales tax base in some provinces with that of the federal GST, and it encourages the government to facilitate this by providing explicit budgetary incentives.

Figure 1. Macroeconomic and Financial Indicators

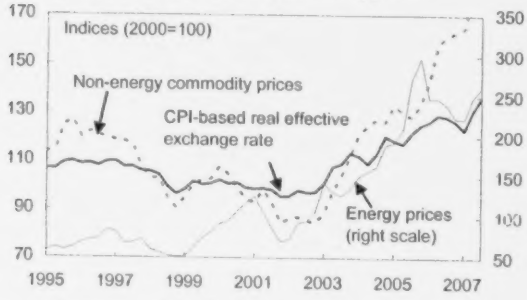
Outlook: Growth is projected to slow, and the risks are on the downside.



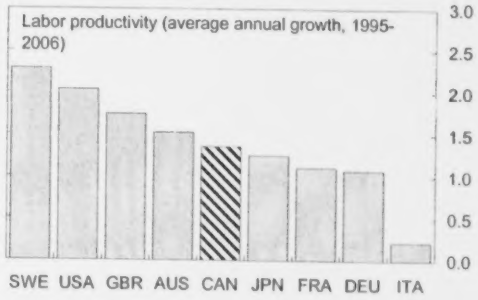
Monetary policy: Inflation concerns have abated, creating room for a forward-looking easing.



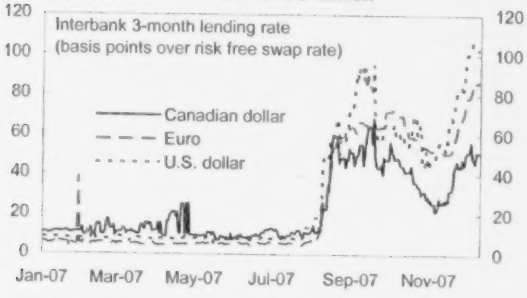
Exchange rate: Much of the recent appreciation of the Canadian dollar reflects rising commodity prices.



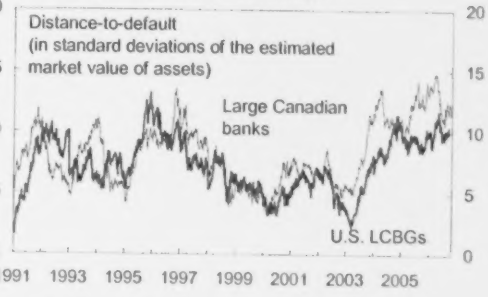
Productivity: Labor productivity growth has been weaker than in many other industrial countries.



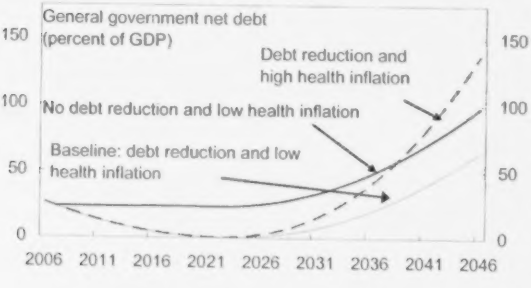
Financial strains: As elsehwere, short-term funding rates have risen with the financial turmoil.



Bank soundness: Canadian banks appear to be in a position to weather financial turbulence.



Fiscal policy: The cautious approach to tax relief is welcome, given long-term spending pressures.



Tax regime: High effective tax rates on capital, particularly in services, hamper competitiveness.